Internal Revenue Service

memorandum

FREV-113006-01
FJZech

date: MAY 0 1 2001

to: Acting Manager, EO Technical Guidance & Quality Assurance T:EO:RA:G
Attn: Lee Phaup

from: Chief, Health and Welfare Branch CC:TE/GE:EB:HW
Division Counsel/Associate Chief Counsel
(Tax Exempt and Government Entities)

subject: Technical Assistance Request - [redacted]

This is in response to your memorandum of February 28, 2001, requesting technical assistance with respect to whether the self-insured medical reimbursement plans funded through the captioned Taxpayer are discriminatory under section 105(h) of the Internal Revenue Code (Code).

The Taxpayer, a trust, was established by the [redacted] to operate as a self-funded multiple employer welfare arrangement. Taxpayer offers group benefits to qualified member employees and their dependents. There are over [redacted] participating medical practices (Employers).

Each adopting Employer may choose from one of four available self-insured accident and health plans. In addition, the Employer can choose to have immediate eligibility or a 30, 60 or 90 day probationary period. The probationary period options do not vary between the available health plans and the probationary period chosen by an Employer applies to all employees of that Employer (i.e., an employer may not have different probationary periods for different classes of employees).

The Employer is required to fund at least 50% of the employee cost for the plan that the Employer offers to its employees. Generally, Employers may not contribute different levels for different types of employees.

Full-time employees of participating Employers and their dependents are eligible for benefits. Full-time is defined as working at least thirty (30) hours a week and being compensated by the Employer with annual reporting of FICA withholdings by means of a W-2 form. Employees who are active or retired members in good standing of the [redacted] are eligible for coverage regardless of whether they are full-time employees. Retired nonphysicians (and their dependents) who were members of the plan immediately prior to retirement, who were at least fifty-five (55) years of age at the time of retirement and who had been an employee of an Employer for at least ten (10) years, are eligible for coverage until they become eligible for Medicare. Retired physicians (and their dependents) who were members of the plan immediately prior to retirement and maintain membership in the [redacted] after retiring are eligible for

coverage until the they become eligible for Medicare regardless of age or years of service. Surviving spouses and the dependents of covered physicians are eligible for coverage until the surviving spouse becomes eligible for Medicare. Surviving spouses and the dependents of covered nonphysicians are eligible for COBRA continuation coverage for up to 36 months.

Section 105(h) of the Code sets forth the nondiscrimination rules for self-insured medical reimbursement plans. Section 105(h)(2)(A) provides that a self-insured medical reimbursement plan satisfies the requirements of section 105(h) only if the plan does not discriminate in favor of Highly Compensated Individuals (HCIs) as to eligibility to participate. In addition, section 105(h)(2)(B) provides that a self-insured medical reimbursement plan satisfies the requirements of section 105(h) only if the benefits provided under the plan do not discriminate in favor of participants who are HCIs.

Discriminatory Benefits

Section 105(h)(2)(B) of the Code and section 1.105-11(c)(3)(i) of the Income Tax Regulations provide that benefits subject to reimbursement under a plan must not discriminate in favor of participants who are HCIs. Plan benefits will not satisfy the requirements of this subparagraph unless all the benefits provided for participants who are HCIs are provided for all other participants. In addition, all the benefits available for the dependents of employees who are HCIs must also be available on the same basis for the dependents of all other employees who are participants.

In the instant case, all four of the plans provide that surviving spouses and dependents of covered physicians are eligible for coverage until the surviving spouse becomes eligible for Medicare. The coverage of surviving spouses and dependents of covered nonphysicians ends upon the death of the covered employee at which point they are only eligible for continuation coverage for up to 36 months. Moreover, at least 50% of the cost of the benefit for surviving spouses or dependents of physicians is paid for by the Employer, while surviving spouses and dependents of nonphysicians must pay the full cost of their coverage under COBRA. Accordingly, If any of the physicians are HCIs, the benefits available for the spouse and dependents of these employees are not available on the same basis to the spouse and dependents of all other employees who are participants and each of the plans, if tested as one plan, discriminates in favor of HCIs under section 1.105-11(c)(3)(i) of the regulations.

Section 1.105-11(c)(4) of the regulations provides that, "A single plan document may be utilized by an employer for two or more separate plans provided that the employer designates the plans that are to be considered separately and the applicable provisions of each plan." Thus, if each of the plans is tested as two separate plans (one for the surviving spouse and dependents of physicians and another plan for everyone else), each plan will pass the benefits test. However, if we assume, as the Taxpayer does in

its submission, that the physicians are HCIs, it is unlikely that the plans could then satisfy eligibility testing (either the percentage tests of section 105(h)(3)(A)(i) or the nondiscriminatory classification test of section 105(h)(3)(A)(ii)).

Eligibility to Participate

Section 105(h)(3)(A) of the Code provides that a self-insured medical reimbursement plan does not satisfy the eligibility requirements unless such plan: (i) benefits 70 percent or more of all employees (the 70% benefit test), or 80 percent or more of all the employees who are eligible to benefit under the plan if 70 percent or more of all employees are eligible to benefit under the plan (the 70/80% test); or (ii) benefits employees who qualify under a classification set up by the employer and found by the Secretary not to be discriminatory in favor of HCIs.

Section 1.105-11(c)(2)(ii) of the regulations provides that whether a plan satisfies the requirements of section 105(h)(3)(A)(ii) will be determined based upon the facts and circumstances of each case applying the same standards as are applied under section 410(b)(1)(B) (relating to qualified pension, profit-sharing and stock bonus plans), without regard to the special rules in section 401(a)(5) (concerning eligibility to participate).

Section 105(h)(3)(B) of the Code provides that, for purposes of determining whether a plan meets the eligibility requirements, there "may be excluded from consideration" employees who have not completed 3 years of service; employees who have not attained age 25; part-time or seasonal employees; employees not included in the plan who are included in a unit of employees covered by a collective bargaining agreement if accident and health benefits were the subject of good faith bargaining; and employees who are nonresident aliens and who receive no earned income from the employer which constitutes income from sources within the United States. With the exception of collectively bargained employees, neither section 105(h)(3)(B) nor the regulations require that these employees be excluded from benefits under the plan as a prerequisite to being excluded from consideration for eligibility testing. That is, the employer may elect to exclude such employees from consideration when testing for eligibility even if they nevertheless participate in the plan. However, if the employer elects to do so, they must be excluded not only in determining the total number of employees, but also in determining the number of employees participating in the plan. In the alternative, the employer may choose to exclude only excludable employees who are not participating in the plan.

In order to determine whether each Employer's self-insured medical reimbursement plan passes the eligibility test, we must compare the nonexcludable participating employees to the total nonexcludable employees. The Taxpayer's response to your December 11, 1999, letter lists only those employees of each Employer who were

excluded from participation because they worked less than 30 hours per week or because they had not worked for the Employer for the 30, 60, or 90 day probationary period elected by the Employer (i.e., "eligible employees" under the plan).

Section 1.105-11(c)(2)(iii)(C) of the regulations provides that part-time employees are employees whose customary weekly employment is less than 25 hours. However, if other employees in similar work with the same employer, or if no employees of the employer are in similar work, other employees in similar work in the same industry work substantially more hours, the employees who work in excess of 25 hours but not more than 35 hours may be considered part-time.

In the instant case, all of the plans exclude nonphysicians having less than 30 hours of work per week. In order to exclude employees working more than 25 hours per week for purposes of applying the percentage tests of section 105(h)(3)(A)(i), the Employers will have to demonstrate that other employees in similar work have substantially more hours.

In addition, because the plans treat some retired employees as employees for purposes of receiving excludable Employer-provided benefits under section 106 of the Code, regardless of age or years of service at retirement, the Employers' must include all retired employees regardless of age and years of service who were covered at retirement in determining total nonexcludable employees for purposes of the percentage tests.

Accordingly, the information provided and currently available is inadequate to determine the number of excludable employees for each Employer. [redacted] Section 105(h)(3)(B), however, is permissive and not mandatory. Thus, Employers are permitted, but not required, to exclude excludable employees from consideration.

If we assume: (1) that the total number of employees for each Employer includes all retired employees regardless of age or years of service who were covered at retirement; (2) that all the part-time employees listed were excludable; and, (3) that the Employer's only intend to exclude those employees listed as probationary or part-time, we believe that in the case of [redacted] of the Employers, it appears that their plans benefitted less than 70% of the eligible employees. Accordingly, these plans appear to fail both

the 70% and the 70/80% tests of section 105(h)(3)(A)(i) of the Code[1].

With respect to the section 105(h)(3)(A)(ii) classification test, if the plan of each Employer, when tested as a separate plan for all employees and as a separate plan for survivors of deceased physicians, can qualify as benefitting a nondiscriminatory classification of employees under the standards that are applied in section 410(b), the Taxpayer would be entitled to a favorable determination. We believe that it is unlikely that survivors of deceased physicians would constitute a nondiscriminatory classification. However, ruling jurisdiction for section 410(b) is with the Employee Plans Rulings and Agreements Division.

To summarize, if tested as one plan, none of the Employers' plans appear to pass the discriminatory benefits test. In addition, based on the numbers provided (subject to the questions raised about the accuracy of those numbers), [redacted] of the Employers' plans do not appear to pass either the 70% or 70/80% eligibility tests. However, if tested as separate plans, the Employers may be able to pass the classification test. Accordingly, an analysis under 410(b) based upon an appropriate calculation of the total nonexcludable employees and nonexcludable participants, is required to ascertain whether the Taxpayer is entitled to a favorable determination.

If you have any questions or if we may be of additional assistance, please contact Felix Zech at 622-6080.

Harry Beker

[1]A list of the Employers having plans that do not appear to benefit at least 70% of their "eligible" employees is attached.